

**REPORT OF EXAMINATION**  
**COMMONWEALTH INSURANCE COMPANY OF AMERICA**

**Seattle, Washington**

**As of December 31, 1998**



**Participating States:**  
**Washington**

**Commonwealth Insurance Company of America**

**CHIEF EXAMINER AFFIDAVIT**

I hereby certify I have read the attached Report of the Financial Examination of Commonwealth Insurance Company of America of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 1998.

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PATRICK H. McNAUGHTON  
Chief Examiner

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Date

**Commonwealth Insurance Company of America**

**TABLE OF CONTENTS**

TABLE OF CONTENTS .....	1
TRANSMITTAL TO COMMISSIONER .....	2
SCOPE OF EXAMINATION .....	2
INSTRUCTIONS .....	3
COMMENTS AND RECOMMENDATIONS .....	5
HISTORY .....	6
MANAGEMENT AND CONTROL .....	6
Shareholders .....	6
Board of Directors .....	7
Officers .....	7
AFFILIATED COMPANIES .....	8
CAPITAL AND SURPLUS .....	9
CORPORATE RECORDS .....	9
INTERNAL SECURITY .....	10
Conflict of Interest .....	10
Fidelity Bond and Other Insurance .....	10
TERRITORY AND PLAN OF OPERATIONS .....	10
GROWTH OF COMPANY .....	11
REINSURANCE .....	11
ACCOUNTING RECORDS AND PROCEDURES .....	13
EDP SYSTEMS AND OPERATIONS .....	16
SUBSEQUENT EVENTS .....	16
FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS .....	17
FINANCIAL STATEMENTS .....	17
Statement of Assets, Liabilities, Surplus and Other Funds .....	18
Underwriting and Investment Exhibit .....	19
Analysis of Examination Changes in Financial Statements .....	20
Comparative Statement of Assets, Liabilities, Surplus and Other Funds .....	21
Comparative Underwriting and Investment Exhibit .....	22
Five Year Reconciliation of Surplus and Other Funds .....	23
NOTES TO THE FINANCIAL STATEMENTS .....	24
ACKNOWLEDGMENT .....	27
AFFIDAVIT .....	28

**Commonwealth Insurance Company of America**

Lacey, Washington  
October 16, 2000

The Honorable Deborah Senn, Commissioner  
Washington Department of Insurance  
Insurance Building  
PO Box 40255  
Olympia, WA 98504-0255

Dear Commissioner Senn:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

**COMMONWEALTH INSURANCE COMPANY OF AMERICA**

of

Seattle, Washington

hereinafter referred to as "CICA" or the "Company," at the location of its parent company's home office, 595 Burrard Street, Suite 1500, Vancouver, British Columbia, Canada V7X 1G4. This report is respectfully submitted showing the condition of the Company as of December 31, 1998.

**SCOPE OF EXAMINATION**

This examination covers the period January 1, 1995 through December 31, 1998 and comprises a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Insurance Code and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination that were noted during the examination. Additionally, the examiners reviewed and utilized the work papers prepared by the Company's independent auditors to the extent possible.

# **Commonwealth Insurance Company of America**

## **INSTRUCTIONS**

The examiners reviewed the Company's filed 1998 Annual Statement as part of the statutory examination. The review focused on determining if the Company's Annual Statement was completed in accordance with the Annual Statement Instructions published by the NAIC and on determining if the Company's accounts and records were prepared and maintained in accordance with Title 48 of the Revised Code of Washington and Title 248 of the Washington Administrative Code.

The following summarizes the exceptions noted while performing this review. The Company is instructed to correct and comply in future Annual Statement filings, per RCW 48.05.250.

### **1. Corporate Bylaws**

- A.** Article II - Section 1 of the Corporate Bylaws states that the annual meeting of the shareholders for the election of directors shall be held within five (5) months after the close of the fiscal year of the Corporation.

RCW 48.07.040 requires each incorporated domestic insurer, in the month of January, February, March or April, to hold the annual meeting of its shareholders or members for the purpose of receiving reports of its affairs and to elect directors.

The Company is instructed to amend Article II - Section 1 of the Corporate Bylaws to change the time period for holding the annual meeting of the shareholders from within five (5) months after the close of the fiscal year of the Corporation to within four (4) months.

- B.** Article III - Section 10 of the Corporate Bylaws states that any director may be removed with or without cause at any time by the shareholders at a special meeting of the shareholders called for that purpose, and may be removed for cause by action of the Board.

RCW 48.07.050 states that the directors of a domestic insurer ..... may be removed with cause by a vote of a majority of its voting capital stock; and said directors ..... may be removed without cause by a vote of sixty-seven percent of its voting capital stock.

The Company is instructed to amend Article III - Section 10 of the Corporate Bylaws to stipulate that directors may be removed with cause by a vote of a majority of its shareholders and said director may be removed without cause by a vote of sixty-seven percent of its shareholders.

## **Commonwealth Insurance Company of America**

### **2. Annual Shareholders Meeting**

The Company is instructed to comply with RCW 48.07.040, which requires each incorporated domestic insurer, in the month of January, February, March or April, to hold the annual meeting of its shareholders or members for the purpose of receiving reports of its affairs and to elect directors. The 1997 Unanimous Written Consent of the Sole Shareholder was dated August 14, 1997.

### **3. Aggregate Excess of Loss Reinsurance Agreement**

- A.** The Company is instructed to amend its Aggregate Excess of Loss Reinsurance Agreement with Commonwealth Insurance Company, the parent company, to include an insolvency provision, as required by RCW 48.12.162(1)(b).
- B.** Until the Excess of Loss Reinsurance Agreement is amended, the Company is instructed not to claim any reserve credits for coverage provided by this agreement when preparing its Annual Statement filings.

### **4. Reinsurance Intermediaries**

Two (2) of the Company's reinsurance intermediaries were not licensed in Washington State or another state with similar regulations. The Company is instructed to:

- A.** Utilize the services of a reinsurance intermediary that is licensed in Washington State or another state with similar regulations, as required by RCW 48.94.010(1).
- B.** Execute written authorization with all of its reinsurance intermediaries, specifying the responsibilities of each party, as required by RCW 48.94.015.
- C.** Have all funds collected by the two (2) non-licensed intermediaries, on behalf of the Company, held by a qualified United States financial institution, as required by RCW 48.94.015(3).

### **5. Invested Assets**

- A.** The Company is instructed to non-admit the portion of its investments that exceeds the 4% limitation established by RCW 48.13.030.
- B.** The Company is instructed to complete Schedule D - Part 1 using Market Rates obtained from the Securities Valuation Office, as required by NAIC

## **Commonwealth Insurance Company of America**

Annual Statement Instructions and RCW 48.05.250.

### **6. Custodial Agreement**

The Company is instructed to:

- A.** Amend its custodial agreement with U.S. Bank of Washington, eliminating Paragraph 2.02-6, which requires approval in writing by the Insurance Commissioner for the withdrawal of assets from the custodian account.
- B.** Open a separate depository account, for the purpose of holding securities held as collateral with the Office of Insurance Commissioner (OIC), and to execute a proper Tri-Party Agreement with the OIC and the bank.

### **7. Schedule E - Part 2 - Special Deposits**

The Company is instructed to report on Schedule E - Part 2 - 'Special Deposits' only such securities that have been placed on deposit with the Washington State Office of Insurance Commissioner or with another state insurance department as Special Deposits Office, as required by NAIC Annual Statement Instructions and RCW 48.05.250.

## **COMMENTS AND RECOMMENDATIONS**

The examination developed the following comments and recommendations calculated to prevent non-compliance in the future.

### **1. Disaster Recovery Plan**

It is recommended that the Company write and test for effectiveness a Disaster Recovery Plan for its EDP system that includes appropriate escalation procedures to resolve operational failures in a timely manner, as promulgated by NAIC Guidelines and RCW 48.07.160.

### **2. Payable to Parent, Subsidiaries and Affiliates**

It is recommended that the Company submit regular quarterly payments to Commonwealth Insurance Company for services and facilities provided pursuant to and in accordance with the terms of the Service and Cost Allocation Agreement.

### **3. Corporate Bylaws**

The Corporate Bylaws do not include any provisions pertaining to the citizenship of

## **Commonwealth Insurance Company of America**

the Directors.

RCW 48.07.050 requires not less than three-fourths of the directors of an incorporated domestic insurer to be United States or Canadian citizens.

It is recommended the Company amend Article III - Section I of the Corporate Bylaws, by adding a new subparagraph, requiring not less than three-fourths of the directors of the Corporation to be United States or Canadian citizens.

### **HISTORY**

Commonwealth Insurance Company of America was incorporated on October 26, 1994 and commenced business on July 1, 1995, as a property and casualty insurance corporation, domiciled in the state of Washington. CICA specializes in underwriting medium to large commercial and industrial property risks; inland and ocean marine for all areas of the oil and gas industry, including petrochemicals; and casualty insurance as additional coverage for U.S. operations of CICA's Canadian policyholders.

The Articles of Incorporation were approved by the Insurance Commissioner, State of Washington, and filed with the Secretary of State, State of Washington.

### **MANAGEMENT AND CONTROL**

#### **Shareholders**

All of the outstanding voting stock of CICA is owned by Commonwealth Insurance Company (CIC), the parent company.

The 1997 Unanimous Written Consent of the Sole Shareholder was dated August 14, 1997. This consent in lieu of the annual meeting of the shareholder did not comply with RCW 48.07.040 (See Instruction No. 2), which states:

“Each incorporated domestic insurer shall, in the month of January, February, March or April, hold the annual meeting of its shareholders or members for the purpose of receiving reports of its affairs and to elect directors.”



## **Commonwealth Insurance Company of America**

### **Board of Directors**

The Board of Directors are responsible for the control and management of the affairs, property and interests of the Company, and may exercise all powers of the Company. In accordance with provisions of the Bylaws, the number of directors are five (5). The Bylaws do not include any type of provision that refers to the citizenship or residency of the directors, and thus, do not comply with RCW 48.07.050 (See Recommendation No. 3), which states,

"Not less than three-fourths of the directors of an incorporated domestic insurer shall be United States or Canadian Citizens."

The lack of any provision restricting citizenship or residency allows for the possibility of compliance with the Bylaws, while at the same time violating RCW 48.07.050, by having less than the three-fourths (75%) of the directors as United State or Canadian citizens.

The following Directors were serving the Company as of December 31, 1998:

	<u>Residence</u>
Edward P. Hunter	Camano Island, WA
Craig A. Hurford	Tsawwassen, BC
Noel E. Phillips	Richmond, BC
Ronald G. Schwab	Vancouver, BC
Jonathan B. Watson	Vancouver, BC

### **Officers**

The administration of Company affairs is directed by Jonathan B. Watson, President. Mr. Watson has over thirty (30) years of insurance experience and has served in this capacity with the Company since its inception and with the parent company since 1970.

The following Officers were serving the Company as of December 31, 1998:

Jonathan B. Watson	President
Ronald G. Schwab	Executive Vice President
Noel E. Phillips	Chief Financial Officer and Treasurer
Edward P. Hunter	Vice President
Craig A. Hurford	Vice President
Elizabeth J. Murphy	Secretary

## **Commonwealth Insurance Company of America**

### **AFFILIATED COMPANIES**

Commonwealth Insurance Company of America is a member of the Fairfax Financial Holding Group (FFHG or “the Group”). On May 15, 1998, 'Form B - Insurance Holding Company System Annual Registration Statement' was filed with the Washington State Office of Insurance Commissioner (OIC). The Group consists of thirty-three (33) property and casualty insurance companies and one (1) life and health insurance company.

#### **Fairfax Financial Holding Limited**

Fairfax Financial Holding Limited (FFH) is the controlling entity of the Group and the ultimate parent company CICA. FFH is a Canadian financial services holding company, primarily engaged in property and casualty insurance and reinsurance throughout the United States, Canada and Europe. The home office is located in Toronto, Ontario, Canada.

#### **Commonwealth Insurance Company**

Commonwealth Insurance Company is the parent company of CICA. CIC is a property and casualty insurance company, registered under the Canadian Insurance Companies Act, specializing as an underwriter of medium to large commercial and industrial risks and worldwide marine and non-marine risks associated with the oil, gas and petrochemical industries. The home office is located in Vancouver, British Columbia, Canada.

On July 1, 1995, the CICA entered into a Service and Cost Allocation Agreement with its parent Company, CIC. By the terms of the agreement, CIC is to provide various management services and office facilities to CICA. The Company agrees to reimburse CIC for services and facilities provided pursuant to this agreement.

#### **Hamblin Watsa Investment Counsel, Ltd.**

Hamblin Watsa Investment Counsel, Ltd. (HWIC), is an affiliate company, founded in 1984. HWIC provides discretionary investment management, primarily to the insurance, reinsurance and subsidiaries of FFHG.

As of September 20, 1996, the Company entered into an Investment Management Agreement with HWIC. On November 5, 1997 a revised Investment Management Agreement was signed by HWIC and CICA, superseding the previous agreement. Per the terms of the current agreement, HWIC has been authorized by CICA to manage the investment accounts of the Company. CICA agrees to reimburse HWIC for the investment services.

## **Commonwealth Insurance Company of America**

### **CAPITAL AND SURPLUS**

In January 1995, the Board of Directors approved the issue of 300,000 shares of authorized and unissued shares of Common Capital Stock, Par Value \$10.00, to the Company's sole shareholder, Commonwealth Insurance Company.

Commonwealth Insurance Company of America has 1,000,000 authorized shares of \$10.00 par value, voting, common stock. As of December 31, 1998, 300,000 shares of common stock were outstanding, with a value of \$3,000,000. Additional Gross Paid In and Contributed Surplus was \$16,929,710. The total paid in capital stock and additional surplus equaled \$19,929,710, exceeding the minimum requirements set forth in RCW 48.05.340. The outstanding shares are wholly-owned by Commonwealth Insurance Company.

During the examination period, the Company received the following contributions to surplus from its parent company, CIC:

1995	\$5,001,000
1996	11,928,710

### **CORPORATE RECORDS**

The examiners reviewed the corporate records of CICA for the period under examination. All Board meetings were conducted with a quorum present. The Board members ratified all changes to the Articles of Incorporation and Bylaws.

A review of the Corporate Bylaws notes that Article II - Section 1 states that the annual meeting of the shareholders for the election of directors shall be held within five (5) months after the close of the fiscal year of the Corporation. This section does not comply with RCW 48.07.050 (See Instructions No. 1A), which states:

“Each incorporated domestic insurer shall, in the month of January, February, March or April, hold the annual meeting of its shareholders or members for the purpose of receiving reports of its affairs and to elect directors.”

It was also noted that Article III - Section 10 of the Corporate Bylaws states that any director may be removed with or without cause at any time by the shareholders at a special meeting of the shareholders called for that purpose, and may be removed for cause by action of the Board. This section of the Corporate Bylaw does not comply with RCW 48.07.050 (See Instructions No. 1B), which states:

## **Commonwealth Insurance Company of America**

“The directors of a domestic insurer ..... may be removed with cause by a vote of a majority of its voting capital stock;” and Said directors ..... may be removed without cause by a vote of sixty-seven percent of its voting capital stock.”

### **INTERNAL SECURITY**

#### **Conflict of Interest**

Commonwealth Insurance Company of America has a Corporate Code of Conduct policy and questionnaire to be signed by the directors, officers and employees for the disclosure of any potential conflicts of interest. The signed statements are reviewed annually for conflicting situations. The Board of Directors reviews any statement that may contain conflicting situations and takes appropriate action there upon.

#### **Fidelity Bond and Other Insurance**

Commonwealth Insurance Company of America is a named insured on an extensive portfolio of insurance providing coverage against all catastrophic and other losses for FFHG and its subsidiaries. The NAIC suggested minimum amounts of fidelity insurance were calculated for CICA at a minimum of \$450,000 - 500,000. As of December 31, 1998, FFHG carries fidelity coverage of \$10,000,000.

### **TERRITORY AND PLAN OF OPERATIONS**

Commonwealth Insurance Company of America is authorized to do business in Alaska, California, Oregon and Washington. The Company is in the process of obtaining authority to conduct its business in every state.

## Commonwealth Insurance Company of America

### GROWTH OF COMPANY

The following schedules reflect the growth of the Company by year beginning in 1995. The amounts shown were compiled from the Company's filed Annual Statements:

#### **Schedule 1**

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Surplus &amp; Other Funds</u>
1998	24,984,673	2,891,663	22,093,010
1997	23,235,065	2,006,717	21,228,348
1996	22,727,861	1,440,862	22,286,999
1995	9,143,689	977,337	8,166,352

#### **Schedule 2**

<u>Year</u>	<u>Premiums Earned</u>	<u>Net Underwriting Deductions</u>	<u>Underwriting Gain or Loss</u>	<u>Investment and Other Income</u>	<u>Pre-Tax Income</u>
1998	758,620	792,887	(34,267)	1,785,024	1,750,757
1997	477,968	488,076	(10,108)	2,117,952	2,107,844
1996	399,099	258,710	140,389	1,123,356	1,263,745
1995	269,878	194,987	74,891	440,842	515,733

### REINSURANCE

Commonwealth Insurance Company of America participates in the quota share and catastrophe treaties of its parent, Commonwealth Insurance Company. Each of these treaties is spread across an extensive portfolio of reinsurers, limiting any concentrated assumed risk. During 1998, CICA ceded premiums of \$2,918,221 (\$90,280 to affiliated companies), which equaled approximately 77% of its Total Direct Written Premiums.

#### **Excess of Loss Reinsurance Agreement**

Commonwealth Insurance Company of America has entered into an Aggregate Excess of Loss Reinsurance Agreement with Commonwealth Insurance Company, its parent. The agreement limits the Company's net losses plus expenses to 105% of Net Written Premiums per fiscal year. However, the agreement does not include an insolvency provision (See Instructions No. 3A), as required by RCW 48.12.162(1)(b), which states:

In the event of insolvency and the appointment of a conservator, liquidator, or statutory successor of the ceding company, the portion of risk or obligation assumed by the reinsurer is payable to the conservator, liquidator,

## **Commonwealth Insurance Company of America**

or statutory successor on the basis of claims allowed against the insolvent company by a court of competent jurisdiction or by a conservator, liquidator, or statutory successor of the company having authority to allow such claims, without diminution because of that insolvency, or because the conservator, liquidator, or statutory successor failed to pay all or a portion of any claims. Payments by the reinsurer as provided in this subsection are made directly to the ceding insurer or to its conservator, liquidator, or statutory successor, except where the contract of insurance, reinsurance, or other written agreement specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer.

The 1998 Annual Statement reported \$288,000 reserve credits for coverage provided by the Aggregate Loss Reinsurance Agreement. Until the agreement includes a proper insolvency provision, the Company is not entitled to claim any reserves credits for coverage provided by the agreement (See Instructions No. 3B).

### **Reinsurance Intermediary**

Commonwealth Insurance Company of America utilizes the services of three (3) reinsurance intermediaries to solicit, negotiate, and place reinsurance cessions on behalf of the Company. A review of the contracts and licenses of these reinsurance intermediaries noted that two (2) intermediaries were not licensed in any state, including Washington State, as required by RCW 48.94.010(1) (See Instructions No. 4A), which requires:

- No person, firm, association, or corporation may act as a reinsurance intermediary-broker in this state if the person, firm, association, or corporation maintains an office either directly or as a member or employee of a firm or association, or an officer, director, or employee of a corporation:
- a. In this state, unless the person, firm, association, or corporation is a licensed reinsurance intermediary-broker in this state; or
  - b. In another state, unless the person, firm, association, or corporation is a licensed reinsurance intermediary-broker in this state having a regulatory scheme substantially similar to this chapter.

The Company was not able to provide evidence of written authorization with each of its reinsurance intermediaries, as required by RCW 48.94.015 (See Instruction No. 4B), which states:

Brokers transactions between a reinsurance intermediary-broker and the insurer it represents in such capacity may be entered into only under a written authorization, specifying the responsibilities of each party.

The funds collected on behalf of the Company by the two (2) non-licensed intermediaries

## **Commonwealth Insurance Company of America**

are not held in a qualified United States financial institution, as required by RCW 48.94.015(3) (See Instructions No. 4C), which requires:

All funds collected for the insurer's account must be held by the reinsurance intermediary-broker in a fiduciary capacity in a bank that is a qualified United States financial institution as defined in this chapter.

### **ACCOUNTING RECORDS AND PROCEDURES**

The Company maintains its accounting records on a Generally Accepted Accounting Principles (GAAP) modified accrual basis of accounting and adjusts to Statutory Accounting Practices (SAP) basis for Annual Statement reporting. The Company is audited annually by the Certified Public Accountants, PricewaterhouseCoopers, LLP, and that firm issued its unqualified opinion for the year ending December 31, 1998.

The Annual Statements filed with the Office of Insurance Commissioner during the examination period were examined and reviewed to verify that they were prepared in a manner consistent with the statutory requirements of Title 48 Revised Code of Washington, Title 284 Washington Administrative Code, the standards and procedures required or prescribed by the Washington Office of Insurance Commissioner and the National Association of Insurance Commissioners. The following areas deviated from these standards and procedures:

#### **Invested Assets**

- C RCW 48.13.030 limits an insurer's investment in a single non-governmental entity to 4% of admitted assets, except with the consent of the Commissioner. The Company's investment in the obligations of Motorola, Inc. exceeds the 4% limit by \$478,048. The portion of the value exceeding the limit should have been reported as a non-admitted asset. (See Instructions No. 5A)
- C RCW 48.13.030 limits an insurer's investment in a single non-governmental entity to 4% of admitted assets, except with the consent of the Commissioner. The Company's investment in the obligations of Northwest Natural Gas exceeds the 4% limit by \$493,981. The portion of the value exceeding the limit should have been reported as a non-admitted asset. (See Instructions No. 5A)
- C Only one (1) of the twenty-four (24) securities listed in Schedule D had a market price that agreed with the NAIC's Securities Valuation Office (SVO) market price. The Company is not using the SVO market price as required by NAIC Annual Statement Instructions and the reported market value was overstated by \$528,518. (See Instructions No. 5B)

## **Commonwealth Insurance Company of America**

### **Custodial Agreement**

Paragraph 2.02-6 of the Company's custodian agreement requires the Insurance Commissioner to approve in writing all withdrawals of trustee assets from the custodial account, similar to the provisions of a Tri-Party Agreement. Paragraph 2.02-6 reads:

The Insurance Commissioner for the State of Washington must approve in writing all withdrawals of trustee Assets in advance, except as follows:

- a. Any and all income, earnings, dividends, or interest accumulations of the trustee Assets may be paid over to the United States manager of the Principal upon request of the Principal or the manager;
- b. Withdrawals coincident with substitutions of securities or assets that are at least equal in value to those being withdrawn, if the substituted securities or assets would be eligible for investment by domestic insurers, and the Principal's United States manager requests the withdrawal in writing under a general or specific written authority previously given or delegated by the Principal's board of directors, or other similar governing body, and a copy of such authority has been filed with the custodian;
- c. For the purpose of making deposits required by another state in which the Principal is, or becomes, an authorized Principal and for the protection of the Principal's policyholders or creditors, or both, in the state or United States, if the withdrawal does not reduce the Principal's deposit in Washington state to an amount less than the minimum deposit required by Washington law. The Custodian shall transfer any assets withdrawn and in the amount required to be deposited to receive the deposit as certified in writing by the public official having supervision of insurance in that state; and
- d. For the purpose of transferring the trustee Assets to an official liquidator, conservator, or rehabilitator under an order of a court of competent jurisdiction.

As written, all of the bonds and short-term investments placed in the custodial account are supposed to be considered by the bank as on deposit with OIC, and as such, should not be withdrawn from the account without the permission of the Commissioner. In actuality, this is not a depository account and the bank has not complied with the provisions of Paragraph 2.02-6 by allowing the Company to withdraw its securities without the approval of the Commissioner. This account was set up for the dual purpose of being a custodial account for all securities and as a depository account for securities held as collateral. This one account cannot serve both purposes. (See Instructions No. 6A and 6B)



## **Commonwealth Insurance Company of America**

### **Schedule E - Part 2 - Special Deposits**

During the examination period, the Company has been reporting on Schedule E - Part 2 - Special Deposits of the Annual Statement that all of its bonds and short-term investments are held on deposit with the OIC, when in fact, the reported balance of securities placed on deposit should be zero. No depository account has been set up with the OIC for special deposits. Until a separate depository account has been set up by the Company for special deposits, the correct balance should be zero. (See Instructions No., 7)

### **Payable to Parent, Subsidiaries and Affiliates**

Per the terms of the Service and Cost Allocation Agreement, CICA agrees to reimburse CIC for services and facilities provided pursuant to this agreement. Charges for such services and facilities will be the lower of:

- i. One hundred percent of all direct and directly allocable expenses, reasonably and equitably determined to be attributable to CICA; or
- ii. Ten percent (10%) of CICA's net written premiums for the calendar quarter.

Within thirty (30) days after the end of each calendar quarter, CIC is to submit to CICA a detailed written statement of the charges due for services and the use of facilities in the preceding calendar quarter, including charges not included in any previous statements. The balances payable are to be paid within thirty (30) days following receipt of such statement.

A review of Company records noted that CIC does not submit to CICA a detailed written statement of the charges due for the preceding quarter, as outlined in the agreement. It was also noted that CICA did not pay to CIC any of the balance due during 1998 or 1999. The payable balance has been steadily increasing each month, at a rate of 10% of the Net Premiums Written. When the issue was brought to the attention of Company officers, CICA paid the payable balance owed to CIC during June 2000. (See Recommendations No. 2)

### **Unpaid Losses and Loss Adjustment Expenses**

The reserves carried by the Company for these liabilities were \$169,670 and \$36,060, respectively, as of December 31, 1998.

These reserves were reviewed by the lead property-casualty actuary employed by the Office of Insurance Commissioner. The actuary used Schedule P loss development data as the basis of his analysis. He obtained additional information by interviewing several Company employees and by reviewing actuarial reports prepared by the Company's appointed actuary.

## **Commonwealth Insurance Company of America**

The actuary's estimates indicate that reserves for losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 1998 Annual Statement.

### **EDP SYSTEMS AND OPERATIONS**

The Management of CICA is sufficiently knowledgeable of EDP issues and the various department managers work with the IS Department to provide direction and oversight. Systems Development, Acquisition and Maintenance Controls were evaluated to gain assurance that programs and systems are designed, tested, approved and implemented using appropriate controls for a company the size of CICA. The Company does not have an Internal Auditor Department. Some oversight is provided by Fairfax Financial Holdings, the ultimate parent, but not in the IS Department.

The Company's EDP services are provided by Commonwealth Insurance Company, the parent company. Operations, processing and documentation controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed and the controls exercised to maintain data security. Adequate procedures and controls are in place for its network, PC's and Year 2000 issues.

The Company has completed testing of its EDP Systems to verify financially significant applications are in compliance with Year 2000 issues. The Company has a detailed, written Business Contingency Plan that ensures it is able to continue providing service to its policyholders in the event of a disruption of normal operations. However, the Company does not have a detailed written Disaster Recovery Plan to ensure its ability to restore network services in the event of a disruption.

### **SUBSEQUENT EVENTS**

#### **Reorganization of Fairfax Financial Holdings Limited**

In a letter to the Office of Insurance Commissioner, dated October 21, 1999, Commonwealth Insurance Company of America outlined a plan to:

- C     Implement a reorganization of Commonwealth Insurance Company (CIC), the parent company, and CICA, whereby each will become wholly-owned subsidiaries of TIG Commonwealth Holdings, Inc., a wholly-owned subsidiary of TIG Insurance Company, (TIG).

## **Commonwealth Insurance Company of America**

- C Ultimate control of CIC and CICA will not be affected by this reorganization because TIG is a wholly-owned subsidiary of Fairfax Financial Holdings Limited, CICA's ultimate parent.
- C The rationale for this reorganization is to strengthen the capitalization of CIC and CICA. TIG has about US\$ 1 billion in capital and surplus, and A.M. Best indicated that it would give CIC and CICA, as subsidiaries of TIG, the financial size rating of TIG. Such financial strength and rating of insurers are becoming increasingly important factors for purchasers of commercial insurance products.

The reorganization was completed December 23, 1999.

### **Certificate of Authority**

During March 2000, CICA obtained a Certificate of Authority from the State of Nebraska.

### **FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS**

The prior Qualifying Examination report, dated January 17, 1995, did not include any Comments and Recommendations, calculated to prevent non-compliance in the future.

### **FINANCIAL STATEMENTS**

The following examination financial statements show the financial condition of Commonwealth Insurance Company of America as of December 31, 1998:

- Statement of Assets, Liabilities, Surplus and Other Funds
- Underwriting and Investment Exhibit
- Analysis of Examination Changes in Financial Statements
- Comparative Statement of Assets, Liabilities, Surplus and Other Funds
- Comparative Underwriting and Investment Exhibit
- Four Year Reconciliation of Surplus and Other Funds

**COMMONWEALTH INSURANCE COMPANY OF AMERICA**  
**Statement of Assets, Liabilities, Surplus and Other Funds**  
**As of December 31, 1998**

	<u>Balance Per Company</u>	<u>Adj. No.</u>	<u>Examination Adjustments</u>	<u>Ref.</u>	<u>Balance Per Examination</u>
<b><u>ASSETS</u></b>					
Bonds	\$ 22,378,950	(1,2)	\$ (972,009)	(2A)	\$ 21,406,941
Cash	1,961,089			(2B)	1,961,089
<b>Subtotals, cash and invested assets</b>	<b>24,340,039</b>		<b>(972,009)</b>		<b>23,368,030</b>
Premiums and agents' balances in course of collection	66,377				66,377
Reinsurance recoverables on loss and loss adjustment expense payment	256,302				256,302
Federal income tax recoverable and interest thereon	-				-
Interest, dividends and real estate income due and accrued	321,955				321,955
<b>Total assets</b>	<b>\$ 24,984,673</b>		<b>\$ (972,009)</b>		<b>\$ 24,012,664</b>
<b><u>LIABILITIES</u></b>					
Losses	\$ 169,670	(3)	\$ 288,000	(7)	\$ 457,670
Loss adjustment expenses	36,060				36,060
Other expenses (excluding taxes, licenses and fees)	32,282				32,282
Taxes, licenses and fees (excluding federal and foreign income taxes)	9,213				9,213
Federal and foreign income taxes (excluding deferred taxes)	185,071			(3)	185,071
Unearned premiums	601,370				601,370
Provision for reinsurance	1,400,171				1,400,171
Excess of statutory reserves over statement reserves	47,000				47,000
Payable to parent, subsidiaries and affiliates	410,826			(4)	410,826
<b>Total liabilities</b>	<b>2,891,663</b>		<b>288,000</b>		<b>3,179,663</b>
<b><u>SURPLUS AND OTHER FUNDS</u></b>					
Common capital stock	3,000,000				3,000,000
Gross paid in and contributed surplus	16,929,710				16,929,710
Unassigned funds (surplus)	2,163,300		(1,260,009)		903,291
<b>Surplus as regards policyholders</b>	<b>22,093,010</b>		<b>(1,260,009)</b>		<b>20,833,001</b>
<b>Total liabilities, surplus and other funds</b>	<b>\$ 24,984,673</b>		<b>\$ (972,009)</b>		<b>\$ 24,012,664</b>

# COMMONWEALTH INSURANCE COMPANY OF AMERICA

## Underwriting and Investment Exhibit

As of December 31, 1998

### STATEMENT OF INCOME

	<u>Balance Per Company</u>	<u>Adj. No.</u>	<u>Examination Adjustments</u>	<u>Ref.</u>	<u>Balance Per Examination</u>
<b><u>UNDERWRITING INCOME</u></b>					
Premiums earned	\$ 758,620				\$ 758,620
DEDUCTIONS					
Losses incurred	545,042	(3)	288,000		833,042
Loss expenses incurred	32,722				32,722
Other underwriting expenses incurred	215,123				215,123
Total underwriting deductions	<u>792,887</u>		<u>288,000</u>		<u>1,080,887</u>
Net underwriting gain or (loss)	<u>(34,267)</u>		<u>(288,000)</u>		<u>(322,267)</u>
<b><u>INVESTMENT INCOME</u></b>					
Net investment income earned	1,454,228			(8)	1,454,228
Net realized capital gains or (losses)	330,796				330,796
Net investment gain or (loss)	<u>1,785,024</u>		<u>-</u>		<u>1,785,024</u>
<b><u>OTHER INCOME</u></b>					
Net gain or (loss) from agents' or premium balances charged off	-				-
Finance and service charges not included in premiums	-				-
Aggregate write-ins for miscellaneous income	-				-
Total other income	<u>-</u>		<u>-</u>		<u>-</u>
Net income before dividends to policyholders and before federal and foreign income taxes	<u>1,750,757</u>		<u>(288,000)</u>		<u>1,462,757</u>
Dividends to policyholders	-				-
Net income, after dividends to policyholders but before federal and foreign income taxes	<u>1,750,757</u>		<u>(288,000)</u>		<u>1,462,757</u>
Federal and foreign income taxes incurred	635,924				635,924
<b>Net income</b>	<b><u>\$ 1,114,833</u></b>		<b><u>\$ (288,000)</u></b>		<b><u>\$ 826,833</u></b>
<b><u>CAPITAL AND SURPLUS ACCOUNT</u></b>					
Surplus as regards policyholders, December 31, prior year	\$ 21,228,348				\$ 21,228,348
<b><u>GAINS AND (LOSSES) IN SURPLUS</u></b>					
Net income	1,114,833	(3)	\$ (288,000)		826,833
Net unrealized capital gains or (losses)	-				-
Change in non-admitted assets	-	(1,2)	(972,009)		(972,009)
Change in provision for reinsurance	(242,171)				(242,171)
Change in excess of statutory reserves over statement reserves	(8,000)				(8,000)
Change in surplus as regards policyholders for the year	<u>864,662</u>		<u>(1,260,009)</u>		<u>(395,347)</u>
<b>Surplus as regards policyholders, December 31, current year</b>	<b><u>\$ 22,093,010</u></b>		<b><u>\$ (1,260,009)</u></b>		<b><u>\$ 20,833,001</u></b>

**COMMONWEALTH INSURANCE COMPANY OF AMERICA**  
**Analysis of Examination Changes in Financial Statements**  
**As of December 31, 1998**

	<b>Adj. No.</b>	<b>INCREASE/ (DECREASE)</b>	
Surplus as regards policyholders, per company			\$ 22,093,010
<b><u>ASSETS</u></b>			
Bonds	(1)	\$ (478,048)	
The Company's investment in the obligations of Motorola, Inc. exceeds the 4% limitation.			
Bonds	(2)	(493,961)	
The Company's investment in the obligations of Northwest Nat'l. Gas exceeds the 4% limitation.			
<b><u>LIABILITIES</u></b>			
Losses	(3)	(288,000)	
Until the Company amends the Aggregate Excess of Loss Treaty to include an insolvency clause, the Company cannot take credits for coverage provided by the treaty.			
<b>Net Increase/(Decrease) to Surplus</b>			<u>(1,260,009)</u>
<b>Surplus as regards policyholders, per examination</b>			<b><u>\$ 20,833,001</u></b>

**COMMONWEALTH INSURANCE COMPANY OF AMERICA**  
**Comparative Statement of Assets, Liabilities, Surplus and Other Funds**  
**As of December 31,**

	<u><b>1998</b></u>	<u><b>1997</b></u>
<u><b>ASSETS</b></u>		
Bonds	\$ 21,406,941	\$ 18,785,545
Cash	1,961,089	3,719,679
<b>Subtotals, cash and invested assets</b>	<b>23,368,030</b>	<b>22,505,224</b>
Premiums and agents' balances in course of collection	66,377	79,922
Reinsurance recoverables on loss and loss adjustment expense payments	256,302	196,950
Federal income tax recoverable and interest thereon	-	185,152
Interest, dividends and real estate income due and accrued	321,955	267,817
<b>Total assets</b>	<b>\$ 24,012,664</b>	<b>\$ 23,235,065</b>
<u><b>LIABILITIES</b></u>		
Losses	\$ 457,670	\$ 124,768
Loss adjustment expenses	36,060	38,098
Other expenses (excluding taxes, licenses and fees)	32,282	39,564
Taxes, licenses and fees (excluding federal and foreign income taxes)	9,213	20,019
Federal and foreign income taxes (excluding deferred taxes)	185,071	-
Unearned premiums	601,370	489,580
Provision for reinsurance	1,400,171	1,158,000
Excess of statutory reserves over statement reserves	47,000	39,000
Payable to parent, subsidiaries and affiliates	410,826	97,688
<b>Total liabilities</b>	<b>3,179,663</b>	<b>2,006,717</b>
<u><b>SURPLUS AND OTHER FUNDS</b></u>		
Common capital stock	3,000,000	3,000,000
Gross paid in and contributed surplus	16,929,710	16,929,710
Unassigned funds (surplus)	903,291	1,298,638
<b>Surplus as regards policyholders</b>	<b>20,833,001</b>	<b>21,228,348</b>
<b>Total liabilities, surplus and other funds</b>	<b>\$ 24,012,664</b>	<b>\$ 23,235,065</b>

**COMMONWEALTH INSURANCE COMPANY OF AMERICA**  
**Comparative Underwriting and Investment Exhibit**  
**For the Years Ended December 31,**

**STATEMENT OF INCOME**

	<u><b>1998</b></u>	<u><b>1997</b></u>
<b><u>UNDERWRITING INCOME</u></b>		
Premiums earned	\$ 758,620	\$ 477,968
DEDUCTIONS		
Losses incurred	833,042	339,791
Loss expenses incurred	32,722	50,246
Other underwriting expenses incurred	215,123	98,039
Total underwriting deductions	<u>1,080,887</u>	<u>488,076</u>
Net underwriting gain or (loss)	<u>(322,267)</u>	<u>(10,108)</u>
<b><u>INVESTMENT INCOME</u></b>		
Net investment income earned	1,454,228	1,326,735
Net realized capital gains or (losses)	330,796	791,217
Net investment gain or (loss)	<u>1,785,024</u>	<u>2,117,952</u>
<b><u>OTHER INCOME</u></b>		
Net gain or (loss) from agents' or premium balances charged off	-	-
Finance and service charges not included in premiums	-	-
Aggregate write-ins for miscellaneous income	-	-
Total other income	<u>-</u>	<u>-</u>
Net income before dividends to policyholders and before federal and foreign income taxes	<u>1,462,757</u>	<u>2,107,844</u>
Dividends to policyholders	-	-
Net income, after dividends to policyholders but before federal and foreign income taxes	<u>1,462,757</u>	<u>2,107,844</u>
Federal and foreign income taxes incurred	635,924	745,094
<b>Net income</b>	<b><u>\$ 826,833</u></b>	<b><u>\$ 1,362,750</u></b>



**COMMONWEALTH INSURANCE COMPANY OF AMERICA**  
**Four Year Reconciliation of Surplus and Other Funds**  
**As of December 31,**

	<u>1998</u>	<u>1997</u>	<u>1996</u>	<u>1995</u>
<b><u>CAPITAL AND SURPLUS ACCOUNT</u></b>				
Surplus as regards policyholders, December 31, prior year	\$ 21,228,348	\$ 21,286,999	\$ 8,166,352	\$ -
<b><u>GAINS AND (LOSSES) IN SURPLUS</u></b>				
Net income	826,833	1,362,750	815,129	317,759
Net unrealized capital gains or (losses)	-	(476,401)	500,808	(24,407)
Change in non-admitted assets	(972,009)	-	-	-
Change in provision for reinsurance	(242,171)	(917,000)	(115,000)	(126,000)
Change in excess of statutory reserves over statement reserves	(8,000)	(28,000)	(9,000)	(2,000)
Capital changes:				
a. Paid in				3,000,000
Surplus adjustments:				
a. Paid in			11,928,710	5,001,000
Change in surplus as regards policyholders for the year	<u>(395,347)</u>	<u>(58,651)</u>	<u>13,120,647</u>	<u>8,166,352</u>
Surplus as regards policyholders, December 31, current year	<u>\$ 20,833,001</u>	<u>\$ 21,228,348</u>	<u>\$ 21,286,999</u>	<u>\$ 8,166,352</u>

# Commonwealth Insurance Company of America

## NOTES TO THE FINANCIAL STATEMENTS

### 1. Basis of Presentation

The financial statements included herein have been prepared in accordance with accounting practices prescribed or permitted by the Washington State Office of Insurance Commissioner. Prescribed statutory accounting practices include a variety of publications of the NAIC, as well as state laws, regulations, and general administrative rules.

### 2. Investments

Investments are valued based on the NAIC's Valuation of Securities Manual and Chapter 48.12 of the Revised Code of Washington.

#### A. Bonds

Bonds are generally reported at amortized cost using the scientific method, which closely approximates the effective interest method. The audited statement values, unrealized gains and losses, estimated market values and acquisition cost of bonds held for investment as of December 31, 1998 were as follows:

	Statement <u>Value</u>	Unrealized Gains/ <u>(Losses)</u>	Market <u>Value</u>	Actual <u>Cost</u>
U.S. Government	\$6,840,710	\$(11,202)	\$6,829,508	\$6,834,621
Political Subdivisions	2,499,407	738,493	3,237,900	3,000,000
Industrial & Misc.	<u>12,066,824</u>	<u>1,314,211</u>	<u>13,381,035</u>	<u>12,577,595</u>
Total	<u>\$21,406,941</u>	<u>\$2,041,502</u>	<u>\$23,448,443</u>	<u>\$22,412,216</u>

The maturity distribution of all bonds owned as of December 31, 1998 was as follows:

	Statement <u>Value</u>	Percent of <u>Portfolio</u>
Due in one year or less	\$ 2,699,189	12.6%
Due over one year through five years	826,624	3.9%
Due over five years through ten years	10,577,293	49.4%
Due over ten years through twenty years	0	0.0%
Over twenty years	<u>7,303,835</u>	<u>34.1%</u>
Total	<u>\$21,406,941</u>	<u>100.0%</u>

## Commonwealth Insurance Company of America

The Securities Valuation Office classification distribution as of December 31, 1998 was as follows:

	Statement Value	Percent of Portfolio
Class 1	\$18,387,878	100.0%
Class 2	<u>3,019,063</u>	<u>100.0%</u>
Total	<u>\$21,406,941</u>	<u>100.0%</u>

### B. Cash And Short-Term Investments

Short-term investments include securities acquired within one (1) year of maturity and are reported at amortized cost, which approximates market value. The statement value of Cash and Short-Term Investments, as of December 31, 1998 were as follows:

Cash	\$ 293,350
Short-Term Investments	<u>1,667,739</u>
Total	<u>\$1,961,089</u>

### 3. Federal Income Tax Allocation

Taxable income differs from statutory income due to capitalization of policy acquisition expenses, discounting of policy reserves and utilization of net operating loss and tax credit carry forwards.

The Company's Federal Income Tax Return is prepared and filed on a individual basis.

### 4. Information Concerning Parent, Subsidiaries and Affiliates

All outstanding common stock shares of the Company are owned by CIC. The Company carries a payable to or receivable from parent and affiliates. The balance includes reinsurance settlements with CIC and charges due CIC for services and the use of facilities. The Service and Cost Allocation Agreement requires balances to be settled quarterly.

### 5. Non-Admitted Assets

Certain assets designated as "non-admitted" have been excluded from the balance sheet. The non-admitted assets are reflected as direct adjustments from net worth. The total non-admitted assets as of December 31, 1998 consisted of the following assets:

## Commonwealth Insurance Company of America

Bonds	\$972,009
Short-term investments	<u>249,866</u>
Total	<u>\$1,221,875</u>

### 6. Reinsurance

Accruals and reserves for property and casualty policies, premium revenues and losses incurred are reported net of reinsurance in the financial statements. Net Written Premiums for the year ending December 31, 1998 is as follows:

	Direct <u>Business</u>	Reinsurance <u>Assumed</u>	Reinsurance <u>Ceded</u>	Net Premiums <u>Written</u>
Total	\$3,788,631	\$0	\$2,918,221	\$870,410
To/From Affiliates		\$0	\$90,280	
To/From All Others		0	2,827,941	

### 7. Loss Reserves

Property and casualty policies had the following reserves for the year ending December 31, 1998:

Case Reserves	\$ 77,669
IBNR	<u>380,001</u>
Total Loss Reserve	<u>\$457,670</u>

### 8. Net Investment Income

The following is a summary of net investment income earned for the year ending December 31, 1998:

Bonds	\$1,429,598
Short-term investments	<u>44,629</u>
Gross investment income	1,474,228
Investment expenses	<u>(20,000)</u>
Net Investment Income	<u>\$1,454,228</u>

## **Commonwealth Insurance Company of America**

### **ACKNOWLEDGMENT**

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers of Commonwealth Insurance Company of America during the course of this examination.

In addition, acknowledgment is made of the participation in the work and preparation to this report by John R. Jacobson, AFE, Examiner-in-Charge; Michael V. Jordan, CPA, CFE, MHP; Lee Barclay, FCAS; all from the Washington Office of Insurance Commissioner.

# Commonwealth Insurance Company of America

# AFFIDAVIT

STATE OF WASHINGTON }  
 } ss  
COUNTY OF THURSTON }

John R. Jacobson, AFE, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of Commonwealth Insurance Company of America was performed in a manner consistent with the standards and procedures required or prescribed by the Washington Office of Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).

John R. Jacobson, AFE  
Examiner-in-Charge  
State of Washington

Subscribed and sworn to before me this \_\_\_\_\_ day of \_\_\_\_\_, 2000.

Notary Public in and for the  
State of Washington, residing  
at Lacey.